

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Bill Hanley on April 25, 2006

DATED: May 2, 2006

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On April 25, 2006, Michael Schachter and Michael Shapiro, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed Bill Hanley from the City of San Diego Metropolitan Wastewater Department ("MWWD"), at the City Administration Building, 202 C Street in San Diego, in a conference room on the third floor. Johnny Giang and Wendy So from KPMG also attended the interview. Mr. Hanley was not represented by counsel.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Bill Hanley, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

#### *Warnings*

Mr. Schachter informed Mr. Hanley that we are counsel to the Audit Committee and do not represent him or any employee. He advised Mr. Hanley that the interview may be considered attorney work product and confidential, but the decision of whether to keep it confidential will be made by the Audit Committee in the best interests of the City, not by Mr. Hanley personally. Mr. Schachter said we will create a report which may contain statements of interviewees, and this report will likely be provided to KPMG and may be released to the public. He said that government agencies may view the report and may be provided with additional information so it is important to be truthful and accurate.

#### *Background*

Mr. Schachter asked Mr. Hanley to describe his work background. Mr. Hanley said that he worked for a management analysis company in San Diego in 1987. The San Diego Clean Water Program selected Montgomery to be its program manager. In 1988, the Council approved the contract with Montgomery and hired Hanley to serve as a consultant on the agreement. In August 1990, he joined San Diego as Deputy Director for Contract Services for the MWWD. He held that position until February 2005.

Mr. Schachter asked Mr. Hanley to describe his responsibilities as Deputy Director for Contract Services. He responded that as Deputy Director for Contract Services, he managed four functions: 1) contract services, which included construction, engineering, program management and upgrade and expansion of the wastewater system; 2) purchasing, which dealt with equipment procurement; 3) financial, which dealt with departmental budgets

and bond financial documents; and 4) support, which included maintenance of administrative facilities, payroll, personnel, and grants and loans including State Revolving Fund (hereinafter "SRF") grants and loans. SRF was a federally funded program in which the State had responsibility for matching the funds. An agency that wanted to participate could take responsibility for the matching funds which gave the agency a better interest rate than if the State did it.

Mr. Schachter asked Mr. Hanley to whom he reported. Mr. Hanley responded that he reported to Dave Schlesinger and then to Scott Tulloch when Schlesinger retired in 2001-2002. From 1990 to 1994, Gene Tagliani reported to him and in 1995, his direct reports included Clay Bingham for financials/bonds, Mick Gammon for support group, and Hedy Griffiths for the fourteen Participating Agencies (hereinafter "PA's").

### *Wastewater*

Mr. Hanley was shown Exhibits 1-14:

- Exhibit 1 is an August 18, 1995 memo from Hedy Griffiths to Bill Hanley, cc to Dave Schlesinger, Ted Bromfield, Kelly Salt, Bill Butler, and Mick Gammon re: "SWRCB Feedback – EPA Grant Project No. C-06-1092," with attached correspondence.
- Exhibit 2 is a February 13, 1997 email from Bill Hanley re: "Kelco sewer bill reductions."
- Exhibit 3 is a March 21, 1997 email from Hedy Griffiths to MWIWL.AXV, SD\_CITY.WU\_CIS.CTS, ccing WZH, SD\_CITY.WU\_MIS.DVW, mwharbor.AXL, CCB, MMM, and others re: "Sewer Classification – Municipal Customers."
- Exhibit 4 is a July 17, 1997 email from Deborah Van Wanseele to WU\_CIS.CTS ccing MWWD.MW\_METRO.WZH re: "Sewer Class changes."
- Exhibit 5 is a July 31, 1997 memo from William Hanley to Distribution re: "Draft Sewer Cost of Service Study."
- Exhibit 6 is an August 8, 1997 memo from William Hanley to Coleman Conrad re: "Implementation of Strength Based Billing."
- Exhibit 7 is an August 13, 1997 letter from Hedy Griffiths to Ron Blair re: "First Quarter Fiscal Year 1998 Invoice to Participating Agencies."
- Exhibit 8 is an August 18, 1997 letter from Mick Gammon to Farouk Ismail re: "State Revolving Fund Loan Program, City of San Diego Applications, Revenue Program Issues."
- Exhibit 9 is a September 22, 1997 letter from Ronald Blair to Hedy Griffiths re: "Approval of Draft Revenue Program – City of San Diego,"

State Revolving Fund (SRF) Loan Projects Nos. C-06-4119-310, C-06-4119-410 and C-06-4119-510.”

- Exhibit 10 is an October 1, 1997 letter from Hedy Griffiths to Ron Blair re: “Acceptance of Chemical Oxygen Demand (COD) Testing.”
- Exhibit 11 is an October 10, 1997 email from Coleman Conrad re: “Kelco Third Quarter TSS Readings –Reply.”
- Exhibit 12 is an October 15, 1997 email from Alan Langworthy to MW\_METRO.WZH ccing cab7-9.city\_mgr.CC1, cab7-9.city\_mgr.D5S re: “Kelco.”
- Exhibit 13 is a November 5, 1997 letter from Coleman Conrad to Steve Zapotoczny re: “Reduction in Suspended Solids – Change in Sewer Classification.”
- Exhibit 14 is a March 26, 1998 memo from Lynn Phelps to Distribution List re: “Notes from meeting on COD Requirements of March 18, 1998.”

### *Right of Way*

Regarding Exhibit 1, an August 18, 1995 memo from Hedy Griffiths to Bill Hanley, cc to Dave Schlesinger, Ted Bromfield, Kelly Salt, Bill Butler, and Mick Gammon, re: “SWRCB Feedback – EPA Grant Project No. C-06-1092,” with attached correspondence, Mr. Schachter asked Mr. Hanley to describe a right of way fee. Mr. Hanley responded that the City implemented a process of charging the water and wastewater utilities a right of way fee. It was developed on an annual basis and incorporated into the budget by the Financial Management Department. He had concerns about the right of way fee. He questioned whether the Enterprise Fund could be used for general fund purposes, which questioned the whole basis and concept of the charge. In complying with the requirements for grants and loans, the charges to the utilities had to be for services provided by the utilities. Mr. Hanley questioned the basis of the right of way charge and its benefits to the utilities. He questioned how the charge was calculated since it was a charge based on utilization of space under the street.

Mr. Schachter asked Mr. Hanley to describe the reaction to the fee and whether the fee still exists. Mr. Hanley replied that there was a general attitude that the fee was a drain on the Enterprise Fund to stabilize the general fund and that there was no real basis for the charge. However, there was a legal opinion saying it was allowable. The annual amount of the charges kept changing and there was no understanding why it varied. Ron Villa of Financial Management informed him of the charge each year and before Villa, Ernie Anderson did so. 2002-2003 was the last year that the utilities paid the charge. It was stopped because there were too many challenges to it, including challenges by the City Council. The San Diego Taxpayer’s Association may also have raised the issue. There was a general feeling that the fee was based on the level of funding received by the general fund and what “they thought they could get away with.” He never formally raised concerns regarding the right of way charge but spoke to David Schlesinger “all the time” informally about the charges.

### *Kelco Loan*

Regarding Exhibit 2, a February 13, 1997 email from Bill Hanley re: "Kelco sewer bill reductions," Mr. Schachter asked Mr. Hanley if he recalled the issue of Kelco being paid \$300,000. Mr. Hanley responded that he recalled the issue and that there was a "giant scramble" on December 31, 1996 to get funds to Kelco before the end of the fiscal year. He received a call from Jack McGrory who questioned whether Kelco was overcharged for wastewater treatment based on flow and TSS. Kelco's TSS classification was adjusted and Kelco received \$300,000 as a loan that was paid back, and a rebate on December 31, 1996, which was based on documentation that showed Kelco's discharge had decreased from the prior year. The rebate was approved. The loan to Kelco looked strange but there was legal documentation supporting it. The City received a check from Kelco paying the loan back but he did not remember if interest was paid. He did not remember how it was characterized on the City's books.

Regarding Exhibit 3, a March 21, 1997 email from Hedy Griffiths to MWIWL.AXV, SD\_CITY.WU\_CIS.CTS, ccing WZH, SD\_CITY.WU\_MIS.DVW, mwharbor.AXL, CCB, MMM, and others re: "Sewer Classification – Municipal Customers," Mr. Schachter asked Mr. Hanley who is "AXV." Mr. Hanley said that "AXV" is Armando Villarino, who tested effluent for Kelco, and CTS is Corinne Smith, who worked in the water department and did wastewater billings.

### *Awareness of Noncompliance*

Mr. Schachter asked Mr. Hanley if he knew in March 1997, that the City needed to allocate for organics. Mr. Hanley responded that in March 1997, he knew that the City needed to allocate costs among TSS, flow and organics. He is not sure when he first understood that the City was not in compliance with State requirements because the City did not allocate for organics. His understanding evolved. Mr. Schachter asked how Mr. Hanley first became aware of the noncompliance issue. He said that an issue was raised with Ron Blair regarding the billing of the PA's and the City started negotiating agreements with the PA's to develop a new agreement, which took effect in 1998. There was a "hard push" to get the process in place for the PA's. The process began with the PA's and the City was looking at the City users second. They started the process for the City users by hiring Hi Point Rendell to do a Cost of Service Study (hereinafter "COS") which was targeted at City users. They did another COS with Pinnacle and then two more with Black & Veatch. There was a recognition that the City had to go to fair and equitable billing and that strength based billing ("SSB") was an acceptable way to do it. It became a major issue in the City when the PA's raised "hell" about the billing process. As the PA's were completed, the focus turned to the City's users. The elected officials did not care about the PA's because they could not vote in San Diego so there was a push to get the PA's agreement into alignment with the requirements but at the same time a recognition that the same had to be done for the City's users.

He recalled that the City was moving in the right direction regarding implementation of SBB. There was a concept that the State Revolving Fund (hereinafter "SRF") loans required implementing SBB but that SBB did not actually have to be implemented for the City to receive the State loans and grants. The City was moving forward in a timely manner to implement SBB but the City's progress fell apart after Black & Veatch I when the issue was

raised to Council about SBB and the State starting to raise questions as to whether the City was moving forward in a timely fashion. He had an understanding at the time that SBB was a regulatory requirement that mandated fair and equitable billing. Mr. Hanley had the understanding then that if you had SBB based on flow, TSS and COD/BOD, you met the requirement for fair and equitable billing but that there were other methods for doing so too. When asked by Mr. Schachter, he said he could not recall the other options but he said he did recall different requirements based on the size of the agency.

### ***SRF Requirements***

Mr. Schachter asked Mr. Hanley if the SRF loans required billing for organics. Mr. Hanley responded that the SRF loans required fair and equitable billing but he did not remember if that billing had to account for organics.

### ***Delay in Implementing SBB***

Mr. Schachter asked why it took so long to implement SBB for City users. Mr. Hanley said that the reason for the delay in implementation until 2004 had to do with "government expediency." The COS was put on the shelf and got "dusty." The normal homeowner was not "in the know" about the State's requirements while the business owners paid a lot of attention. The San Diego Taxpayer's Association looked out for the homeowner but the Chamber of Commerce, the hotel/motel association, the restaurant association, and individual entities like Kelco, were politically active and knew the impact of adding COD/BOD to the billing structure. Why the implementation of SBB for the City users was handled in the manner in which it was handled has to do with the upper levels of City government and Mr. Hanley was not privy to that information. He said that during Black & Veatch I and II there was a stakeholders' process which include Kelco, the hotels/motels, the restaurant owners, and Sony. There were some representatives from the homeowners' association but the major voices were businesses. Kelco fought SBB "tooth and nail." Black & Veatch I got shelved but he is not sure why. It was at that time that Councilmember Frye questioned when the COS would be completed. George Loveland wrote a memo to the Mayor and Council and a decision was made to update the COS. It was his impression that the Mayor's Office helped Kelco to delay the change. Mr. Schachter asked Mr. Hanley if the City Manager's Office was involved in the delay. He responded that the players in the City Manager's Office between Black & Veatch I and II were Mike Uberagua who did not have a big role, Loveland who was involved and handed the issue off to Richard Mendes. Mendes worked under Loveland and was Tulloch's boss, and seemed involved in it. He did not recall Coleman Conrad slowing down the process of changing the sewer rate structure but it "just seemed to have happened." He did not know who slowed down the process. There was enough attention at that time that no one could have slowed it down without someone in the Mayor's office working with those who wanted the COS delayed. Mr. Schachter asked Mr. Hanley if he was aware of any political contributions influencing anyone or policy decisions. Mr. Hanley was not.

Regarding Exhibit 4, a July 17, 1997 email from Deborah Van Wanseele to WU\_CIS.CTS, cc to MWWD.MW\_METRO.WZH re: "Sewer Class changes," Mr. Schachter asked who was Debora Van Wanseele. Mr. Hanley said that Debora Van Wanseele is in the billing area of the MWWD. In 1991, the Clean Water Program (hereinafter "CWP") separated from the Utilities Department. CWP was responsible for planning, design, and construction of

upgrades of the wastewater system while day to day operations stayed with the water utilities department. In 1992, MWWD was created which included day to day operations, maintenance and upgrading of the wastewater system. The billing process stayed with the water department. He did not know the requirement to which Van Wanseele is referring.

Regarding Exhibit 5, a July 31, 1997 memo from William Hanley to Distribution re: "Draft Sewer Cost of Service Study," Mr. Hanley said that the COS did mandate billing based on COD/BOD. Regarding Exhibit 6, an August 8, 1997 memo from William Hanley to Coleman Conrad re: "Implementation of Strength Based Billing," Mr. Schachter asked Mr. Hanley why he wrote the memo. Mr. Hanley said that the purpose in writing the memo was to give Conrad an update about the implications of SBB. They were targeting implementation for Fiscal Year 1999, which would include billing based on COD/BOD for City users. Coleman Conrad was the Deputy City Manager and Schlesinger's boss at the time and Hanley remembered dealing with Conrad. He never had the perception that Conrad was opposed to SBB or that there was a strong push in favor of it, either.

### *State Awareness of Noncompliance*

Regarding Exhibits 7, an August 13, 1997 letter from Hedy Griffiths to Ron Blair re: "First Quarter Fiscal Year 1998 Invoice to Participating Agencies," and Exhibit 8, an August 18, 1997 letter from Mick Gammon to Farouk Ismail re: "State Revolving Fund Loan Program, City of San Diego Applications, Revenue Program Issues," Mr. Schachter asked Mr. Hanley if Ron Blair was under a misimpression that the City was in compliance. Mr. Hanley responded that Blair was not under a misimpression that there was compliance among the City users. The concentration in communications with Blair addressed the PA's because that was the State's concern. Blair had received a complaint from the PA's and Hanley did not know if Blair knew in 1997 of noncompliance among City users. He did not remember conversations regarding the State's knowledge at that time.

### *Cost of COS*

Mr. Schachter asked Mr. Hanley about how a COS originates and what one typically costs. Mr. Hanley said that the COS was lead by Financing Services. He did not recall how much a COS costs but it is not cheap. The Black & Veatch COS cost between \$500,000 and \$1 million. He did not recall discussions regarding why the COS was not going forward to Council.

### *Other Dealings with Kelco*

Regarding Exhibit 11, an October 10, 1997 email from Coleman Conrad re: "Kelco Third Quarter TSS Readings -Reply," Mr. Hanley did not remember specifics. He said Exhibit 11 dealt with a loan or adjustment issue but does not remember discussions about it. The environment at the time was one of pushing the legal envelope. He defined "pushing the legal envelope" as "don't break the law but benefit the business community." Mr. Hanley recalled discussions that Kelco was a good employer and corporate citizen.

Mr. Hanley was shown Exhibits 15-22:

- Exhibit 15 is an October 21, 1998 memo from David Schlesinger to Distribution re: "Regional Wastewater Disposal Agreement – Review by State Water Resources Central Board."
- Exhibit 16 is an October 23, 1998 email from Bill Hanley to CAB7-9.FM(MEV) re: "memo to Zapoticzny –Reply."
- Exhibit 17 is an October 26, 1998 letter from Susan Hamilton to Stephen Zapoticzny re: "Cost of Services Study for Municipal Wastewater Services."
- Exhibit 18 is a November 3, 1998 email from Bill Hanley to MW\_ADMIN(sch) ccing cab7-9.city\_mgr(d5s, gil), re: "Kelco –Reply."
- Exhibit 19 is a November 12, 1998 email from Bill Hanley to George Loveland, Dave Schlesinger and Susan Hamilton, cc to Phil Moffitt, Hedy Griffiths, Clay Bromfield, Ted Bromfield and others re: "Meeting with Kelco – Strength Based Billing."
- Exhibit 20 is a November 18, 1998 memo from City Attorney to Bill Hanley re: "System Charges Requirements."
- Exhibit 21 is a November 20, 1998 email from Philip Moffitt to EZA re: "Strength Based Surcharge," attaching a November 20, 1998 email from Dave Schlesinger to Eric Adachi re: "Strength Based Surcharge."
- Exhibit 22 is a document authored by David McKinley entitled, "COD-Based Sewer Rate Issues."

Regarding Exhibit 16, an October 23, 1998 email from Bill Hanley to CAB7-9.FM(MEV) re: "memo to Zapoticzny –Reply," Mr. Schachter asked Mr. Hanley why the document is stamped "business sensitive." Mr. Hanley responded that he had two stamps, a confidential stamp and a "business sensitive" stamp. If the City was in negotiations concerning business, he would stamp a document "business sensitive." After finalizing the Wastewater Disposal Agreement, the City may have been looking at going forward with another item with Kelco and that was why he stamped it "business sensitive."

Regarding Exhibit 19, a November 12, 1998 email from Bill Hanley to George Loveland, Dave Schlesinger and Susan Hamilton, cc to Phil Moffitt, Hedy Griffiths, Clay Bromfield, Ted Bromfield and others re: "Meeting with Kelco – Strength Based Billing," Mr. Schachter asked Mr. Hanley to describe the meeting that took place. Mr. Hanley said he had a number of meetings with Zapoticzny. The impact on Kelco of SBB was a major concern but he never told Zapoticzny that there maybe was no need to change to COD. The issues with Kelco revolved around Kelco taking the position that SBB should not apply to them. Kelco raised questions regarding SBB and how the three elements impacted the treatment of wastewater. Secondary treatment usually treats COD/BOD but Kelco cannot include COD/BOD because Kelco's wastewater went to Point Loma which does not handle COD/BOD. The City's response was that Point Loma was a regional wastewater system and that the billing process takes into

account the system, not the plant. Kelco threatened, either impliedly or expressly, to leave San Diego. Mr. Schachter asked Mr. Hanley if Kelco threatened Mr. Hanley personally. He responded that Kelco did not threaten him that he could lose his job and he did not hear from other employees that Kelco said that either. McKinley worked for Zapoteczny and "had a shorter fuse." ISP processed kelp while CPKelco traded in base materials needed to create products. NutraSweet/Monsanto owned Kelco in 1996-1997.

Mr. Schachter asked Mr. Hanley to discuss Kelco's involvement with the rate structure issue. Mr. Hanley said that Kelco was politically active and he assumed that Kelco was a political contributor to the Council. He perceived Kelco's influence based on the period between Black & Veatch I and II when issues were brought through Mendes from the Mayor's Office. Mendes said the Mayor's office had an interest in Kelco regarding SBB. He and Mendes attended meetings with Tom Story regarding what could/could not be done for Kelco. The meetings with Story and Mendes took place on the 11<sup>th</sup> floor, after June 2004. The discussion centered around what could be done for Kelco to help them implement programs to reduce the strength of their wastewater. If Kelco reduced its strength, the question was whether there was a benefit to the wastewater system. He was always concerned about rates and that they be implemented in a timely fashion so the wastewater department would have enough money to upgrade the sewer system.

### *System Charges*

Regarding Exhibit 20, a November 18, 1998 memo from City Attorney to Bill Hanley re: "System Charges Requirements," Mr. Schachter asked Mr. Hanley why he asked Bromfield to prepare this document. Mr. Hanley replied that he did not remember why he asked Bromfield to prepare this but he is "sure someone is challenging our rights to do it." Regarding Exhibit 21, a November 20, 1998 email from Philip Moffitt to EZA re: "Strength Based Surcharge," attaching a November 20, 1998 email from Dave Schlesinger to Eric Adachi re: "Strength Based Surcharge," Mr. Schachter asked Mr. Hanley if the Council meeting referenced was delayed. Mr. Hanley responded that he did not remember if the Council meeting was delayed. He said "this is just about increasing rates not changing the structure."

Mr. Hanley was shown Exhibits 23-29:

- o Exhibit 23 is a December 2, 1998 document entitled, "Required Items for the Wastewater System Preliminary Official Statement (Sorted by Responsible Party)."
- o Exhibit 24 is a December 7, 1998 document entitled, "City of San Diego, California, Wastewater System, Interested Parties List."
- o Exhibit 25 is a December 14, 1998 letter from David McKinley to Bill Hanley re: "Specific Problems with Wastewater Strength-Based Cost Allocation Factors."
- o Exhibit 26 is a December 21, 1998 fax from Bill Hanley to Ted Bromfield attaching the first page of Exhibit 25.



- o Exhibit 27 is a December 28, 1998 fax from Bill Hanley to George Loveland attaching a December 28, 1998 point paper on SBB.
- o Exhibit 28 is a December 30, 1998 email from Hedy Griffiths to WZH, cc LCM, M1S, re: "SWRCB – Ron Blair and Kelco."
- o Exhibit 29 is a January 4, 1999 document entitled, "City of San Diego Metropolitan Wastewater Department Sewer Revenue Fund Cost of Services Study Strength Based Billing."
- o Exhibit 30 is the 1999 POS.

### *Disclosure*

Regarding Exhibit 23, a December 2, 1998 document entitled, "Required Items for the Wastewater System Preliminary Official Statement (Sorted by Responsible Party)," Mr. Schachter asked Mr. Hanley to describe the process involved with the Preliminary Official Statement. Mr. Hanley said that the process for Preliminary Official Statement (hereinafter "POS") preparation was the responsibility of Financing Services which took the lead for the City. In December 1998, Kahlie and Eric Adachi were the two Financing Services employees most responsible. Phil Moffitt was replaced by Adachi and Joe Harris was replaced by Moffitt. Mr. Hanley said he did not participate in the 1993 offering. For later offerings, the prior POS was used as a template and the sections were assigned to people by Financing Services to update them. The wastewater department was responsible for the Bingham/Hanley items. After the sections were updated, the base document was controlled by Orrick, first by Jenna Magan and then in 2003 by Dan Deaton. Page turners took place in the City Administration Building on the 5<sup>th</sup> or 6<sup>th</sup> floor and there was more than one page turner per offering. There may have only been one page turner for 2003. They would literally go page by page and any questions would be raised. Either a response would be provided to questions raised there or an action item would be posted to obtain clarification after the meeting ended. Mr. Schachter asked who played a role at the POS meetings in 2003. Mr. Hanley stated that the players in the POS meetings in 2003 were Kahlie, Adachi, Salt, Bingham, Wochaski, Webber/Magan, DeRose (who provided advice regarding what the market would be looking for), Hanley and maybe Bromfield and Vattimo.

Mr. Schachter asked Mr. Hanley about Paul Webber and whether Webber was pro or anti-disclosure. Mr. Hanley responded that Paul Webber was bond counsel and went through the document and asked questions. Mr. Hanley characterized the page turner as a "due diligent process" and said it was his perception that Webber was pro-disclosure. Mr. Schachter asked Mr. Hanley if he could recall what disclosure issues were discussed during the POS meetings. Mr. Hanley responded that there was discussion regarding the pension issues in 2003 and what should go in the bond disclosure. There was discussion regarding what needed to be said regarding the sewer fund because the sewer fund contributed to the pension fund at a different rate than the general fund. There were discussions regarding how to handle the different rates and how the UAAL should be handled for the sewer fund. They came to the conclusion that the sewer fund particulars needed to be included in the POS. There was a perception that the sewer fund was in better shape than the general fund because the sewer fund had contributed at a higher rate than the general fund so the UAAL was better off. The page turner occurred before the bond players went to New York and the issue was pulled.

Mr. Hanley was shown Exhibit 30, the 1999 POS. Mr. Schachter asked Mr. Hanley to review pages 22 and 23. Mr. Hanley referenced pages 22-23 and said "it doesn't talk to municipal customers." He recalled discussion either in 1999 or 2003 regarding where they were at with the COS. Both he and Kahlie felt the need to move forward with the COS because of the potential \$370 million liability. Their attitude went from "ok" that the COS was being done and the City intended to do it, to the point where there did not seem to be the political will to go forward with it. The "disallowed" language was a "glaring red light" and he said it was discussed in the context of the page turners. Mr. Schachter asked Mr. Hanley how the "disallowed" language became part of the POS. Mr. Hanley did not know how the "disallowed" language got into the POS.

Mr. Schachter asked Mr. Hanley if Webber was made aware of the COS or of the issue of noncompliance. Mr. Hanley responded that he did not recall any conversation at all during the bond issuance about the COS. He could not say whether Webber knew of the City's noncompliance. Mr. Hanley could not say whether Webber was aware of the COS. He believes Webber was aware because the POS was discussed and Webber was present. He did not remember discussions during the POS meetings regarding the State's requirements and the City's noncompliance. Mr. Hanley believes discussions took place regarding the fact that the rates needed to be in compliance with the State. He explained that there is a difference in interpretation between the concept of having implemented something and being in the process of implementing something. People relied on the concept of the process being implemented rather than the implementation already having occurred. The noncompliance started to bother him when the COS was shelved. When the COS was shelved, he believed the City was "really stretching" its argument that it was in the process of complying. It was then questionable whether the City was acting in a good faith manner. He felt the City was in the process of complying and he wondered whether that was acceptable and whether it met the State's requirements. Cities all over California were implementing SBB and there was a perception that the State was providing time to do it but there probably was a limit to the amount of time being given.

### ***Point Paper***

Regarding Exhibit 27, a December 28, 1998 fax from Bill Hanley to George Loveland attaching a December 28, 1998 point paper on SBB, Mr. Hanley said that he assumes Loveland was involved with SBB. He prepared a point paper to highlight some specific areas. Mr. Schachter asked Mr. Hanley why Exhibit 27 was stamped "business sensitive." Mr. Hanley did not remember why it is stamped "business sensitive" but it was probably stamped that way because it dealt with Kelco.

### ***Blair's Awareness of Noncompliance***

Regarding Exhibit 28, a December 30, 1998 email from Hedy Griffiths to WZH, cc LCM, M1S, re: "SWRCB – Ron Blair and Kelco," Mr. Schachter asked Mr. Hanley what he interprets the email referencing Blair to mean. Mr. Hanley said that Griffiths was relating a conversation with Blair and he reads it as if Blair thought the City already charged for BOD.

### ***Stakeholders' Group***

Mr. Hanley was shown Exhibit 31, a document entitled, "Sewer Cost of Service Stakeholders' Group Final Report September 14, 2000-May 3, 2001." Mr. Schachter asked Mr. Hanley to describe the report's conclusions. Mr. Hanley replied that the report said it was mandatory to allocate based on TSS, flow, and BOD/COD.

*September 17, 1999 Memo*

Mr. Hanley was shown Exhibit 32, a September 17, 1999 memo from William Hanley to Dennis Kahlie re: "SRF Loan Document Issues." Mr. Schachter asked if Mr. Hanley prepared the document and if so, why he prepared it. Mr. Hanley responded that he prepared Section D and did so in response to a memo from Kahlie. He did not recall Darlene DeRose asking questions. Mr. Schachter asked Mr. Hanley why he did not disclose the noncompliance in this document. Mr. Hanley said he did not remember why he did not disclose the noncompliance. He answered on the basis of implementation of SBB including the three elements. While the City had not done so by 1999, he still felt the City was trying to get there. He did not remember why he wrote it as he did. Mr. Schachter asked Mr. Hanley if he recalled anyone telling him to answer narrowly. He said he did not remember anyone telling him to answer narrowly.

Mr. Hanley was shown Exhibits 33-39:

- Exhibit 33 is an October 19, 1999 email from Dave Schlesinger to George Loveland and Larry Gardner, ccing Bill Hanley, Dennis Kahlie, Penny Culberth-Graft and others re: "Water and Sewer Cost of Services Studies."
- Exhibit 34 is an October 20, 1999 email from Dave Schlesinger to Myrna Zambrano ccing Bill Hanley, Dennis Kahlie, George Loveland, and others re: "Re: a couple of questions."
- Exhibit 35, an October 6, 1999 memo from George Loveland to the Honorable Mayor and City Council re: "Water and Sewer Cost of Services Studies."
- Exhibit 36 is a November 3, 1999 email from Dennis Kahlie to CCP.MANAGER.GIL, ptf, and mev re: "Meeting with Chris Kehoe Nov 2 Re Cost of Services Study."
- Exhibit 37 is a November 1, 1999 email from Dave Schlesinger to George Loveland, cc Bill Hanley, Dennis Kahlie, Kelly Salt and others, re: "Grand Jury Review of Sewer Rates."
- Exhibit 38 is a December 3, 1999 memo from George Loveland to the Honorable Mayor and City Council re: "Wastewater System Financing Plan."
- Exhibit 39 is a January 11, 2000 document entitled, "Discussion of Waiver Renewal Status and Implications of OPRA-Based Discharge

Standards for Purposes of Rating Agency Update and Continuing Disclosure."

*The COS 1998-1999*

Mr. Schachter asked Mr. Hanley if he received the May 1998 COS. Mr. Hanley said he is "pretty sure" he received the May 1998 COS. Mr. Schachter asked Mr. Hanley if he was party to discussions regarding "what to do now." Mr. Hanley replied in the affirmative. He said he is sure he had discussions with Kahlie, Adachi, and Schlesinger regarding the need to implement it. The general perception was that the proposed changes discussed in the COS were not implemented because someone above MWWD and Financing Services did not want it to go forward. It was his perception that the City Manager's Office was "squashing it" and some City officials were doing so as well

Regarding Exhibit 33, an October 19, 1999 email from Dave Schlesinger to George Loveland and Larry Gardner, cc to Bill Hanley, Dennis Kahlie, Penny Culberth-Graft and others, re: "Water and Sewer Cost of Services Studies," Mr. Schachter asked Mr. Hanley if he recalled the substance of the email. Mr. Hanley responded that he recalled speaking with Schlesinger after the COS was sent to the Mayor and Council. He recalled someone speaking with Schlesinger regarding the COS but did not specifically remember it was Kehoe. He did not recall any discussion regarding a misleading cover letter or "damage control." Mr. Schachter asked Mr. Hanley if he would have expected a discussion between Schlesinger and a Deputy City Manager regarding the misleading memo. Mr. Hanley replied in the affirmative.

Regarding Exhibit 34, an October 20, 1999 email from Dave Schlesinger to Myrna Zambrano, cc to Bill Hanley, Dennis Kahlie, George Loveland, and others re: "Re: a couple of questions," Mr. Schachter asked Mr. Hanley if he recalled why the COS was not released for two years. Mr. Hanley replied that he did not.

Mr. Hanley was also shown Exhibit 35, an October 6, 1999 memo from George Loveland to the Mayor and City Council re: "Water and Sewer Cost of Services Studies." Mr. Schachter asked about Mr. Hanley's knowledge of this document. Mr. Hanley said he has seen the October 6, 1999 memo before but had no role in preparing it. He recalled someone from Council, maybe Kehoe, asking where the COS was. The COS was done and it said that fair and equitable billing would shift rates to business and there would be an impact on commercial customers. Businesses were politically active and did not want the COS implemented. He had the perception that businesses were able to influence elected officials to have the COS held off as long as possible. He said that Loveland felt it was necessary to issue the COS to the Mayor and Council but he did not know who told Loveland to do so. Mr. Hanley said it was important to get the study out to everyone at the same time if it was going to be released. He noted that Loveland's memo transmitted two COS's to the Mayor and Council and he assumed that before the transmittal someone asked why the COS had not been released. The memo "raises real grey areas as to whether San Diego was working towards compliance."

Regarding Exhibit 36, a November 3, 1999 email from Dennis Kahlie to CCP.MANAGER.GIL, ptf, and mev re: "Meeting with Chris Kehoe Nov 2 Re Cost of Services Study," Mr. Schachter asked Mr. Hanley what he understands from the email. Mr. Hanley

replied that he reads the email to say that Blair does not know that the City is out of compliance but that Kahlie will tell Blair if Blair asks about it.

Regarding Exhibit 37, a November 1, 1999 email from Dave Schlesinger to George Loveland, cc to Bill Hanley, Dennis Kahlie, Kelly Salt and others re: "Grand Jury Review of Sewer Rates," Mr. Schachter asked about Mr. Hanley's involvement in the grand jury proceedings. Mr. Hanley said that he made a presentation to the grand jury about billing the PA's. Barry Newman from the Metro Sewer Task Force was on the jury.

Regarding Exhibit 39, a January 11, 2000 document entitled, "Discussion of Waiver Renewal Status and Implications of OPRA-Based Discharge Standards for Purposes of Rating Agency Update and Continuing Disclosure," Mr. Schachter asked Mr. Hanley to explain the substance of the document. Mr. Hanley said the City was looking for another OPRA waiver. Mr. Schachter asked Mr. Hanley to define a "base case." Mr. Hanley replied that the base case is the comparison of changes between OPRA I and II.

Mr. Hanley was shown Exhibits 40-46:

- Exhibit 40 is a May 3, 2000 email from Eric Adachi to Barbara Sharatz, Bill Hanley, Christine Ruess and others re: "Cost of Service Study Kick-off Meeting."
- Exhibit 41 is a September 5, 2000 fax transmittal from Eric Adachi to Sudhir Pardiwala re: correspondence from Blair with the City.
- Exhibit 42 is a September 12, 2000 fax transmittal from Eric Adachi to Sudhir Pardiwala and Prabha Kumar, attaching letters from the State to the City regarding COD implementation.
- Exhibit 43 is a September 19, 2000 email from Dave Schlesinger to Dennis Kahlie, Frank Belock, Ron Kole, Bill Hanley and Alan Langworthy re: "Sewer Cost of Service."
- Exhibit 44 is a September 29, 2000 email from Bill Hanley to Dennis Kahlie re: "Sewer Cost of Service," attaching a September 28, 2000 email from [KeeseCo@aol.com](mailto:KeeseCo@aol.com) to WZH re: "Comments regarding David McKinley."
- Exhibit 45 is an email from Patricia Tennyson to Sudhir Pardiwala, Dennis Kahlie, [eza@proc2000.sannet.gov](mailto:eza@proc2000.sannet.gov), [HRG@sdcity.sannet.gov](mailto:HRG@sdcity.sannet.gov), [WZH@sdcity.sannet.gov](mailto:WZH@sdcity.sannet.gov) re: "Comments Re Karen Keese's E-mail."
- Exhibit 46 is the May 1998 COS.

### *The COS in 2000*

Regarding Exhibit 40, a May 3, 2000 email from Eric Adachi to Barbara Sharatz, Bill Hanley, Christine Ruess and others re: "Cost of Service Study Kick-off Meeting," Mr. Schachter asked Mr. Hanley why there was a COS kickoff meeting taking place in 2000. Mr.

Hanley responded that this COS kickoff started the Black & Veatch process but he did not recall who said to update the COS. Regarding Exhibit 41, a September 5, 2000 fax transmittal from Eric Adachi to Sudhir Pardiwala re: correspondence from Blair with the City, Mr. Schachter asked if Mr. Hanley recalled the discussion referenced with Eric Adachi. Mr. Hanley replied that he did not recall a conversation with Adachi but did recall general discussions. He did not recall if Blair knew of the noncompliance. Regarding Exhibit 43, a September 19, 2000 email from Dave Schlesinger to Dennis Kahlie, Frank Belock, Ron Kole, Bill Hanley and Alan Langworthy re: "Sewer Cost of Service," Mr. Schachter asked Mr. Hanley to describe what was being discussed in this email. Mr. Hanley replied that he thinks it dealt with the stakeholders' group and that there was a decision to brief the group as a whole and not give Kelco special treatment. After the stakeholders' group completed their process, the documentation, including the COS, was received by the City. The COS was put on hold but he did not know why. He assumed word came down from elected officials that they did not want to see it. He was sure he would have spoken with Kahlie and Adachi about the COS being shelved. He recalled a general attitude that elected officials did not want to see an impact on commercial customers.

Regarding Exhibit 44, a September 29, 2000 email from Bill Hanley to Dennis Kahlie re: "Sewer Cost of Service," attaching a September 28, 2000 email from KeeseCo@aol.com to WZH re: "Comments regarding David McKinley," Mr. Schachter asked Mr. Hanley who was Karyn Keese. Mr. Hanley replied that Ms. Keese was an individual on the stakeholders' group who was also a consultant to the PA's. She had financial expertise. Kelco was arguing that the criteria for the PA's was wrong. Keese felt the correct process was used to implement SBB for the PA's. He thought that Keese interfaced with McKinley regarding his proposals. Mr. Hanley did not recall reviewing the document.

Mr. Hanley was shown Exhibits 47-55:

- Exhibit 47 is a June 28, 2001 email from Eric Adachi to Bill Hanley re: "Fwd: Suggested Edits," attaching a June 28, 2001 email from Dennis Kahlie to Eric Adachi, Prabha Kumar, Sudhir Pardiwalla and Ron Blair re: "Suggested Edits," attaching a draft letter to Kahlie from Blair.
- Exhibit 48 is a July 10, 2001 letter from Ron Blair to Dennis Kahlie re: "Wastewater Revenue Program Cost Allocation Method – City of San Diego (City), Clean Water Grant (CWG) Projects Nos. C-06-1092 and C-06-3014; State Revolving Fund (SRF) Loan Projects Nos. C-06-4119, C-06-4383, C-06-4542, C-06-4650, C-06-4690 and C-06-4718."
- Exhibit 49 is an October 6, 2001 email from Scott Tulloch to Dennis Kahlie, Lisa Irvine, Patricia Frazier, Aimee Faucett, Dan Coffey, Jim Madaffer, Leslie Perkins and Bill Hanley re: "Fwd: Fw: San Diego Sewer Rate Increase."
- Exhibit 50 is an October 10, 2001 City Manager's Report to the Honorable Mayor and City Council re: "Sewer Revenue Fund, Sewer Service Charges."

- Exhibit 51 is a document entitled, "City Manager's Docket Briefing Agenda for the City Council Meetings of October 15 and 16, 2001," with handwritten notes.
- Exhibit 52 is an October 17, 2001 email from Scott Tulloch to Bill Hanley and Dennis Kahlie re: "Fwd: Well Done," attaching an October 16, 2001 email from Casey Gwinn to Scott Tulloch, ccing Ted Bromfield and Kelly Salt re: "Well Done."
- Exhibit 53 is an October 17, 2001 email from Dennis Kahlie to Scott Tulloch, cc to Bill Hanley and Eric Adachi re: "Fwd: Well Done."
- Exhibit 54 is an October 18, 2001 email from Kelly Salt to Ed Ryan, Dennis Kahlie, Mary Vattimo, Casey Gwinn, Keri Katz, Ted Bromfield, George Loveland, Patricia Frazier, Paul Webber, Scott Tulloch, and Bill Hanley re: "Sewer Cost of Service Study and Prop 218."
- Exhibit 55 is an October 23, 2001 email from Bill Hanley to Dennis Kahlie, Clifton Williams, Susan Hamilton and Scott Tulloch re: "Cost of Service Study."

#### *Awareness and Status of COS in 2001 and 2002*

Regarding Exhibit 48, a July 10, 2001 letter from Ron Blair to Dennis Kahlie re: "Wastewater Revenue Program Cost Allocation Method – City of San Diego (City), Clean Water Grant (CWG) Projects Nos. C-06-1092 and C-06-3014; State Revolving Fund (SRF) Loan Projects Nos. C-06-4119, C-06-4383, C-06-4542, C-06-4650, C-06-4690 and C-06-4718," Mr. Schachter asked Mr. Hanley if the document suggested to Hanley that Blair believed the City is taking into account organics. Mr. Hanley replied that the document did suggest that Blair believed the City was taking into account organics and that the City was in compliance with the State requirements. He, Kahlie, and Adachi discussed the implications of SBB and that the grants and loans could be in jeopardy. Mr. Hanley was fairly sure that he discussed it with Schlesinger and later with Tulloch. He thought he had discussions with the City Manager's Office.

Mr. Schachter asked Mr. Hanley whether the issue of noncompliance had become a big issue by this time. Mr. Hanley said that by this point, it had become a big issue. Some Council members wanted it implemented while others did not. Councilmember Frye was raising questions as to where the COS was. During the Fiscal Year 2002 budget hearing, which may have been in May 2002, Frye raised questions to Schlesinger and his staff about where was the COS. He recalled believing it was discussed in closed session. He recalled the Mayor saying they did not have it, that it did not exist. Mr. Hanley had discussions with Schlesinger and Tulloch at the time about the fact that at the Council meeting, no one from Financing Services said anything when the Mayor said the COS had not been received yet. After the meeting, he talked with others about how Financing Services did not speak up and that it was their responsibility to do so because the COS was their document.

Regarding Exhibit 49, an October 6, 2001 email from Scott Tulloch to Dennis Kahlie, Lisa Irvine, Patricia Frazier, Aimee Faucett, Dan Coffey, Jim Madaffer, Leslie Perkins and Bill Hanley re: "Fwd: Fw: San Diego Sewer Rate Increase," Mr. Schachter asked if the email concerned changing the rate structure. Mr. Hanley replied that it did not and that the City was going forward with proposed rate increases, not SBB, but restaurants still raised concerns. He thinks Tulloch was trying to say the rate increases had nothing to do with the COS because the COS was revenue neutral. He did not recall why the COS was not going to Council until December 2001. Mr. Hanley recalled discussion regarding the timing of changing the rate structure and increasing rates, and that they should not be brought forward together because it would be confusing.

Regarding Exhibit 51, a document entitled, "City Manager's Docket Briefing Agenda for the City Council Meetings of October 15 and 16, 2001," with handwritten notes, Mr. Schachter asked Mr. Hanley to explain the document. Mr. Hanley said that the document was put together by Ed Plank, Council Liaison. Plank pulled together the briefing for the Council members before the Council meeting. The briefing was chaired by Plank and held in closed session on the 12<sup>th</sup> Floor of the City Administration Building. City staff was available to answer questions during the briefings. Exhibit 51 is a briefing for the City Manager, usually provided to Ewell or Loveland, because Uberagua did not normally attend. The second briefing is for Council staff.

Regarding Exhibit 52, an October 17, 2001 email from Scott Tulloch to Bill Hanley and Dennis Kahlie re: "Fwd: Well Done," attaching an October 16, 2001 email from Casey Gwinn to Scott Tulloch, cc to Ted Bromfield and Kelly Salt re: "Well Done," Mr. Schachter asked why the COS is referenced. Mr. Hanley did not remember. Regarding Exhibit 54, an October 18, 2001 email from Kelly Salt to Ed Ryan, Dennis Kahlie, Mary Vattimo, Casey Gwinn, Keri Katz, Ted Bromfield, George Loveland, Patricia Frazier, Paul Webber, Scott Tulloch, and Bill Hanley re: "Sewer Cost of Service Study and Prop 218," Mr. Schachter asked why Proposition 218 was being addressed but not the noncompliance. Mr. Hanley responded that the City believed it should comply with Proposition 218 regarding sewer charges in an abundance of caution even though it was probably not necessary. There was a feeling that Proposition 218 had to be addressed and did not think there was any political attitude against addressing it while with the COS, some politicians did not want to see it go forward.

Regarding Exhibit 55, an October 23, 2001 email from Bill Hanley to Dennis Kahlie, Clifton Williams, Susan Hamilton and Scott Tulloch re: "Cost of Service Study," Mr. Schachter asked Mr. Hanley who Clifton Williams is. Mr. Hanley said that Clifton Williams is a staffer to a Councilman, probably for Peters, and was the "lead guy" regarding utility issues. Mr. Hanley recalled meeting with Williams and Kahlie regarding the COS. He normally met with Williams regarding sewer charges, not the COS.

Mr. Hanley was shown Exhibit 56, a November 19, 2001 email from Dennis Kahlie to Clifton Williams, cc to Bill Hanley re: "Cost of Service Phase-In." Mr. Schachter asked Mr. Hanley if he recalled discussion regarding mitigating the impact on commercial customers of implementing SBB. Mr. Hanley said that he recalled a concept of how to mitigate the impact on commercial customers. He and Kahlie felt it was time to implement SBB and was sure that Kahlie was speaking with Blair about it. It was time to do it and the reasonable time period had passed.



Mr. Hanley was shown Exhibits 57-62:

- Exhibit 57 is a December 6, 2001 email from Bill Hanley re: "Closed Session Memo."
- Exhibit 58 is a January 15, 2002 COS.
- Exhibit 59 is a January 30, 2002 email from Bill Hanley re: "Cost of Services Study."
- Exhibit 60 is a January 25, 2002 email from Bill Hanley to Dennis Kahlie and Eric Adachi re: "Fwd: Restaurants."
- Exhibit 61 is a February 1, 2002 email from Dennis Kahlie to Mary Vattimo and Patricia Frazier re: "Revenue Plan Issues."
- Exhibit 62 is a December 6, 2001 memo from City Attorney to the Honorable Mayor and City Council re: "The Application of Article XIIID to Sewer Fees."

### *January 2002 Closed Session*

Mr. Schachter asked Mr. Hanley if he was present for the January 29, 2002 closed session. Mr. Hanley was not present. Referring to Exhibit 57, a December 6, 2001 email from Bill Hanley re: "Closed Session Memo," Mr. Schachter asked if Exhibit 62, a December 6, 2001 memo from City Attorney to the Honorable Mayor and City Council re: "The Application of Article XIIID to Sewer Fees," is the memo being referenced. Mr. Hanley said he did not know. Regarding Exhibit 58, a January 15, 2002 COS, Mr. Schachter asked Mr. Hanley if it was a draft. Mr. Hanley did not know if it was a draft but it could be a final document.

Regarding Exhibit 59, a January 30, 2002 email from Bill Hanley re: "Cost of Services Study," Mr. Schachter asked Mr. Hanley if he was aware that the City Attorney's Office was going to examine the issues raised by the January 29, 2002 closed session presentation by Kahlie. Mr. Hanley replied that he remembered discussions with Kahlie regarding the fact that the City Attorney's Office was going to analyze the issues raised in the January 29, 2002 closed session. The Council's referral of the issue to the City Attorney's issue was a "pocket veto." He did not recall Kahlie saying anything regarding Councilman Madaffer. The COS was just going to the City management: Mendes, Bob Ferrier, the City Auditor, and not the Council.

### *Contract Extension*

Regarding Exhibit 60, a January 25, 2002 email from Bill Hanley to Dennis Kahlie and Eric Adachi re: "Fwd: Restaurants," Mr. Schachter asked Mr. Hanley what is being discussed in the email. Mr. Hanley said that Kahlie was talking about making an amendment to the Black & Veatch contract for \$3,200. In this email, Hanley is telling Kahlie to do it. Mr. Schachter asked why Mr. Hanley is being asked by Kahlie. Mr. Hanley said he is being asked because the issue is the availability of sewer funds to pay for it. Mr. Schachter asked Mr. Hanley how he reads the comment "...if we're now going to blow off the findings...this'll end up being the world's first half million dollar cost of service study." Mr. Hanley said he takes it to mean

that if the City disregards the findings of the stakeholders' group and does more sensitivities for Mendes, the cost of the study will increase. Mr. Schachter asked Mr. Hanley to explain what a sensitivity is. Mr. Hanley said that sensitivities are related to the formula to allocate costs.

### ***SRF Loan Issue***

Regarding Exhibit 61, a February 1, 2002 email from Dennis Kahlie to Mary Vattimo and Patricia Frazier re: "Revenue Plan Issues," Mr. Schachter asked Mr. Hanley what was the issue being discussed. Mr. Hanley said that the issue was whether they could go forward with SRF grant applications. The language in the SRF loans create a potential conflict with the bond covenants and they were trying to resolve the issue. An issue arose when the State leveraged loan capacity by issuing the bond. They needed to reconcile the covenants with the City's bond covenants. He did not think it had to do with the sewer user rate structure but rather had to deal with subordination.

Mr. Hanley was shown Exhibits 63-71:

- Exhibit 63 is a February 13, 2002 email from Virginia Magan re: "1999 San Diego Sewer – Official Statement – Request for Updates."
- Exhibit 64 is a November 8, 2002 email from Dennis Kahlie to Patricia Frazier re: "Cost of Service Bullet Points," attaching a November 11, 2002 document entitled, "Salient Points Sewer Cost of Service Compliance Issue."
- Exhibit 65 is a March 6, 2003 email from Dennis Kahlie to Keri Katz, Leslie Devaney, Richard Mendes, Scott Tulloch and Bill Hanley re: "Cost of service study-questions," attaching a March 6, 2003 memo from the Utilities Finance Administrator to Keri Katz re: "Information Requested Relative to Utility Cost of Service Studies."
- Exhibit 66 is an April 24, 2003 memo from City Attorney to Eric Adachi, Jenna Magan, and Bill Hanley re: "Revised POS for 2003 Sewer Revenue Bonds."
- Exhibit 67 is a June 4, 2003 email from Lara Orr to Eric Adachi re: "Rating Agency Presentation," attaching a document entitled, "City of San Diego – Wastewater System, Rating Presentation Itinerary."
- Exhibit 68 is a June 6, 2003 email from Darlene DeRose to Daniel Deaton, William Webster, Andy Mukerji, Beth Fernando, Carol O'Hanlon, Chia Yang, Clay Bingham, Dennis Kahlie, Ed Burdett, Edward Wochaski, Eric Adachi, Eric Tashman, Grace Barvin, Jack Anderson, John Costagliola, [karmstrong@kbcap.com](mailto:karmstrong@kbcap.com), Kelly Salt, Krishna Pettit, Mark Adler, Mary Vattimo, Raymond Day, Stepan Haytayan, Ted Bromfield, Tom Innis, Wesley Ogburn and William Hanley, ccing Paul Webber, Virginia Magan, and Larry Sobel re: "City of San Diego Wastewater – Revised Preliminary Official Statement."

- Exhibit 69 is a June 9, 2003 email from Eric Adachi to Dennis Kahlie re: "City of San Diego Wastewater – Revised 2003 Supplement," attaching a June 3, 2003 letter from Ted Bromfield to Dan Deaton re: "Revisions in 2003 POS re: Collection System."
- Exhibit 70 is a June 11, 2003 email from Paul Webber to Darlene DeRose, William Webster, Andy Mukerji, Beth Fernando, Carol O'Hanlon, Chia Yang, Clay Bingham, Dennis Kahlie, Ed Burdett, Edward Wochaski, Eric Adachi, Eric Tashman, Grace Barvin, Jack Anderson, John Costagliola, [karmstrong@kbcap.com](mailto:karmstrong@kbcap.com), Kelly Salt, Krishna Pettit, Mark Adler, Mary Vattimo, Raymond Day, Stepan Haytayan, Ted Bromfield, Tom Innis, Wesley Ogburn and William Hanley, cc to Paul Webber, Virginia Magan, Larry Sobel, and Dan Deaton re: "City of San Diego – Wastewater System, Sewer Revenue Bonds, Series 2003 – Revised POS."
- Exhibit 71 is a June 19, 2003 email from Darlene DeRose to Dennis Kahlie, Eric Adachi, John Costagliola, Tom Innis, William Hanley, Clay Bingham and Ed Wochaski re: "Ratings Presentation," attaching a June 25, 2003 rating agency presentation.

### ***COS 2002-2003***

Regarding Exhibit 64, a November 8, 2002 email from Dennis Kahlie to Patricia Frazier re: "Cost of Service Bullet Points," attaching a November 11, 2002 document entitled, "Salient Points Sewer Cost of Service Compliance Issue," Mr. Schachter asked Mr. Hanley if he had seen the document before. Mr. Hanley said that the document looked familiar and he remembered the issue went to Closed Session one time before the Fiscal Year 2002 budget presentation. Mr. Schachter asked Mr. Hanley if he recalled another closed session being scheduled and later cancelled. Mr. Hanley said he did not. Regarding Exhibit 65, a March 6, 2003 email from Dennis Kahlie to Keri Katz, Leslie Devaney, Richard Mendes, Scott Tulloch and Bill Hanley re: "Cost of service study-questions," attaching a March 6, 2003 memo from the Utilities Finance Administrator to Keri Katz re: "Information Requested Relative to Utility Cost of Service Studies," Mr. Schachter asked Mr. Hanley if he knew why Kahlie prepared the memo. Mr. Hanley said he did not remember why Kahlie prepared the memo but he remembered Frye having raised questions about the COS. Keri Katz was the City attorney assigned to the NR&C Committee. It appeared that Katz was taking the lead at the City Attorney's Office in obtaining a response for Frye. He did not have any discussions with Kahlie regarding providing information to Frye. He and Kahlie were concerned about the issue of whether the City was dragging its feet. He felt that there was some rational basis to say that the City was moving forward until Black & Veatch I but at this point in 2002, people were questioning whether the City was acting in good faith. Sooner or later the State was going to say it was time to implement the rate structure change.

### ***2003 POS***

Regarding Exhibits 66-69, an April 24, 2003 memo from City Attorney to Eric Adachi, Jenna Magan, and Bill Hanley re: "Revised POS for 2003 Sewer Revenue Bonds." Exhibit 67 is a June 4, 2003 email from Lara Orr to Eric Adachi re: "Rating Agency

Presentation,” attaching a document entitled, “City of San Diego – Wastewater System, Rating Presentation Itinerary,” a June 6, 2003 email from Darlene DeRose to Daniel Deaton, William Webster, Andy Mukerji, Beth Fernando, Carol O’Hanlon, Chia Yang, Clay Bingham, Dennis Kahlie, Ed Burdett, Edward Wochaski, Eric Adachi, Eric Tashman, Grace Barvin, Jack Anderson, John Costagliola, [karmstrong@kbcap.com](mailto:karmstrong@kbcap.com), Kelly Salt, Krishna Pettit, Mark Adler, Mary Vattimo, Raymond Day, Stepan Haytayan, Ted Bromfield, Tom Innis, Wesley Ogburn and William Hanley, cc to Paul Webber, Virginia Magan, and Larry Sobel re: “City of San Diego Wastewater – Revised Preliminary Official Statement,” and a June 9, 2003 email from Eric Adachi to Dennis Kahlie re: “City of San Diego Wastewater – Revised 2003 Supplement,” attaching a June 3, 2003 letter from Ted Bromfield to Dan Deaton re: “Revisions in 2003 POS re: Collection System,” Mr. Schachter asked Mr. Hanley if he recalled whether noncompliance was addressed in the 2003 POS. Mr. Hanley replied that he had a recollection that noncompliance was not addressed in the 2003 draft POS. He did not recall saying anything about noncompliance during the page turners. It was his feeling that the City Manager’s Office and senior management, including the City Auditor, were aware of the issue and they were responsible for the issue. He did not think it needed to be pointed out to them. He probably should have said something. Probably almost everyone at the POS meeting knew about the issue including Salt, Kahlie, and Adachi. He cannot remember anyone raising the issue there.

Regarding Exhibit 68, a June 6, 2003 email from Darlene DeRose to Daniel Deaton, William Webster, Andy Mukerji, Beth Fernando, Carol O’Hanlon, Chia Yang, Clay Bingham, Dennis Kahlie, Ed Burdett, Edward Wochaski, Eric Adachi, Eric Tashman, Grace Barvin, Jack Anderson, John Costagliola, [karmstrong@kbcap.com](mailto:karmstrong@kbcap.com), Kelly Salt, Krishna Pettit, Mark Adler, Mary Vattimo, Raymond Day, Stepan Haytayan, Ted Bromfield, Tom Innis, Wesley Ogburn and William Hanley, ccing Paul Webber, Virginia Magan, and Larry Sobel re: “City of San Diego Wastewater – Revised Preliminary Official Statement,” Mr. Schachter asked Mr. Hanley if revisions were made to the POS. Mr. Hanley replied that there were revisions made to the POS, including to the relevant section. He did not specifically recall a discussion regarding noncompliance.

Mr. Schachter asked how far the bond issuance went before it was pulled and why it was pulled. Mr. Hanley said that the bond issuance went far: Kahlie and Adachi were in New York and getting pricing before it was actually pulled. The intent upon pulling the 2003 POS was to make some changes to it and then release it in two weeks. It was pulled because of pension financial issues.

### ***Rating Agency Disclosure***

Mr. Hanley was shown Exhibits 72-75:

- Exhibit 72 is a June 30, 2002 email from Bill Hanley to Dennis Kahlie, Eric Adachi and Clay Bingham re: “Fwd: FITCH’S Follow-up Questions,” attaching a June 27, 2003 email from Mark Capell to Bill Hanley re: “Follow-up Questions.”
- Exhibit 73 is a June 30, 2003 email from Dennis Kahlie re: “Follow-up Questions.”

- Exhibit 74 is a July 1, 2003 email from Dennis Kahlie to Ted Bromfield, Eric Adachi, Clay Bingham and Bill Hanley re: "Proposed Responses To Fitch's Questions," attaching a redline document entitled, "Proposed Responses to Fitch's Questions."
- Exhibit 75 is a July 1, 2003 email from Bill Hanley to Mark Capell, Dennis Kahlie and Eric Adachi re: "Follow-up Questions," attaching a document entitled, "Responses to Follow-up Questions."

Mr. Schachter asked whether the issue of noncompliance was discussed during preparation for the rating agency presentations. Mr. Hanley responded that when preparing for the rating agency presentations, he recalled that issues were raised as to whether or not the COS and the noncompliance should be disclosed. One or both of the issues were addressed in the presentations.

Mr. Schachter asked Mr. Hanley if the issue of noncompliance was discussed during the rating agency presentations. Mr. Hanley said that he attended the rating agency presentations but did not recall discussing the issue of noncompliance. He recalled it was a concern whether to disclose the noncompliance to the rating agencies because the City had not yet implemented SBB. He and Kahlie had discussed the potential impact of noncompliance but did not discuss disclosing it to the bond rating agencies. He "sidestepped" the issue of disclosing to the agencies because he looked at it as a Financing Services issue because they had the lead on the COS and the rating agency presentations.

Regarding Exhibit 72, a June 30, 2002 email from Bill Hanley to Dennis Kahlie, Eric Adachi and Clay Bingham re: "Fwd: FITCH'S Follow-up Questions," attaching a June 27, 2003 email from Mark Capell to Bill Hanley re: "Follow-up Questions," item number three, Mr. Schachter asked Mr. Hanley whether Fitch was interested in whether the City was in compliance. Mr. Hanley responded that yes, Fitch was interested in whether or not San Diego was in compliance. Regarding Exhibit 73, a June 30, 2003 email from Dennis Kahlie re: "Follow-up Questions," Mr. Hanley said that John Costagliola was a consultant on the bond issuance. He noted that Kahlie is discussing the same questions from Exhibit 72. Mr. Schachter asked Mr. Hanley if he spoke with Kahlie about how to respond to Fitch. Mr. Hanley said he would have had discussions with Kahlie regarding how to respond to Fitch.

Regarding Exhibit 74, a July 1, 2003 email from Dennis Kahlie to Ted Bromfield, Eric Adachi, Clay Bingham and Bill Hanley re: "Proposed Responses To Fitch's Questions," attaching a redline document entitled, "Proposed Responses to Fitch's Questions," response to item number three, Mr. Schachter asked with whom did Hanley discuss the issue. Mr. Hanley said he did not remember. Mr. Schachter asked Mr. Hanley why the issue of noncompliance was not being disclosed to Fitch. Mr. Hanley said he was "sidestepping" the issue of the State not approving the COS and the COS not being implemented. Mr. Hanley stated that at that point, it was "really questionable" whether anything was being done to implement the COS. He could not remember anyone specifically working on it. Mr. Schachter asked if the response to item number 3 was Hanley's response and if so, why Hanley responded that way. Mr. Hanley said he believed it was his response. He said he responded to item number three on the basis that if the City was not in compliance it would have a negative impact on the bond ratings. If he told the rating agencies about the noncompliance it would have raised questions in their minds as to the

sewer department's ability to go into the bond market and could maybe affect how much money could be raised. He said "the less cycles to go through" the sooner "the bond could go to market." Mr. Schachter asked Mr. Hanley if spoke with Ted Bromfield about his response. Mr. Hanley said that he alone prepared it and did not recall speaking with Bromfield about it.

Johnny Giang from KPMG asked Mr. Hanley why noncompliance was not disclosed to the rating agencies. Mr. Hanley said that looking back, there was concern about impacting or holding up the process to issue bonds. There was no question that they would be able to issue the bonds but if questions were raised and answered, the process would have been delayed, which would have delayed the issuance which, in turn, would have impacted construction of sewer projects. He said that at the time, he rationalized that he responded to the questions asked. He did not give Fitch "more than was asked for." He cannot even remember with whom he reviewed the answers. No one told him how to answer the questions or told him that they did not want the noncompliance issue addressed. Mr. Hanley said that the COS process had stopped and there appeared to be no action at the time regarding the COS. However, he may have rationalized in his mind that he answered the questions but did not provide additional information.

Mr. Hanley was shown Exhibits 76-80:

- Exhibit 76 is a September 11, 2003 email from David Schlesinger to Joe Harris ccing [wst@sanidiego.gov](mailto:wst@sanidiego.gov), Bill Hanley, and [axl@sanidiego.gov](mailto:axl@sanidiego.gov) re: "BOD Sewer Charge: Follow-up Meeting – Wednesday, September10, 9:15 a.m..."
- Exhibit 77 is a September 12, 2003 email from Bill Hanley to Dennis Kahlie, Eric Adachi, Robert Ferrier and Scott Tulloch re: "Sewer Revenue Bonds."
- Exhibit 78 is an October 3, 2003 letter from Sudhir Pardiwala and Prabha Kumar to Dennis Kahlie re: "Sewer Cost of Service and Rate Design Report."
- Exhibit 79 is an October 9, 2003 email from Bill Hanley to Richard Mendes, Dennis Kahlie, Eric Adachi, and Scott Tulloch re: "Sewer Cost of Service Report," attaching a document entitled, "Wastewater Cost of Services Report."
- Exhibit 80 is a October 14, 2003 email from Dennis Kahlie to Richard Mendes, Eric Adachi, Scott Tulloch and Bill Hanley re: "Sewer Cost of Service Report," attaching a document entitled, "Wastewater Cost of Services Report."

### ***COS Implementation***

Regarding Exhibit 76, a September 11, 2003 email from David Schlesinger to Joe Harris, cc to [wst@sanidiego.gov](mailto:wst@sanidiego.gov), Bill Hanley, and [axl@sanidiego.gov](mailto:axl@sanidiego.gov) re: "BOD Sewer Charge: Follow-up Meeting – Wednesday, September10, 9:15 a.m...", Mr. Schachter asked Mr. Hanley

to describe how the COS was finally implemented. Mr. Hanley said that in May 2002, issues were raised during the budget process which led to updating the COS. Correspondence with Blair raised the issue of noncompliance which spurred Black & Veatch II. He did not know why the City Council did not take up the issue in November 2003 and was not sure when it was taken up.

Mr. Hanley was shown Exhibits 81 and 82. Exhibit 81 is a May 4, 2004 email from Dennis Kahlie to Bill Hanley, Kelly Salt and Richard Mendes re: "Fwd: Cost of Service: Original Agreement." Exhibit 82 is a May 12, 2004 email from Bill Hanley re: "Fwd: Due Diligence Questions for Tomorrow." Mr. Schachter asked Mr. Hanley if he knew why Kahlie wrote Exhibit 81. Mr. Hanley said that it was his perception that Kahlie wrote Exhibit 81 in response to Mendes's question.

### ***Interactions with the City Auditor and KPMG***

Mr. Giang asked Mr. Hanley about his interactions with the City Auditor and with KPMG. Mr. Hanley said that he worked very closely with the City Auditor's Office regarding funding requirements. During the bond issuance process, Financing Services took the lead. The majority of the time he and his staff worked on the POS, they worked on the areas they were responsible for but did not spend much time on the other sections. He worked "very very closely" with Ed Wochaski on financial statements and everything else regarding the sewer system financials. He said he would be asked the status of the wastewater system and questions relevant to cost accounting and provided input to Wochaski. Mr. Hanley had interaction with KPMG, generally about the PA's and about cost accounting among divisions. Before KPMG, the City used Calderon and he had major interface with Calderon regarding the review process for the PA's since Calderon oversaw cost allocation to the PA's.

### ***Cost Allocations from General Fund to Enterprise Fund***

Mr. Schachter asked Mr. Hanley if there is anything else we should be aware of. He said we covered right of way but did not discuss cost allocations of the general fund to the enterprise fund and that we should take "a hard look at it." The issue involves indirect costs and how they are distributed between accounts. This was done with the "downtown people," including the Auditor and Financial Management. It was a major concern for the PA's. He said the General Fund was raiding the Enterprise Fund. He explained that for indirect costs, for example, costs for the City Auditor's Office, the sewer Enterprise Fund was being billed for the services of other employees. There is nothing improper about it but he questioned whether the formulas that are used to do the calculations are correct. The areas the PA's had concern about included the indirect cost allocations (overheads), the service level agreements between groups within the City (some done on a direct basis, some indirect), and whether they were properly aligned.

### ***Conclusion***

Mr. Schachter asked Mr. Hanley whether he has observed any City employee or member of the government doing something they thought was wrong and Mr. Hanley said, "no." Mr. Schachter requested that Mr. Hanley keep the interview confidential. Mr. Schachter told Mr. Hanley to contact us if he recalls any new information in the future.

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